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PACKAGE DESIGN COST

ISSUE

Are costs incurred for a package design capital expenditures under Code section 263?

DEFINITION OF PACKAGE DESIGN COSTS

In order to further clarify the issue, a definition of package design, and the costs included in that definition, will be helpful at this point. Package design can be defined as the exclusive right of a manufacture of processor to use a specific arrangement of items (such as letters, colors, pictures, trademarks, trade names, etc.) on its product package and/or to use a unique container shape in order to identify its product and attract customers. The property involved here is the right to use an arrangement or container shape. This right is not tangible. A comparison can be made with the rights obtained in a patent, which grant the exclusive right to a product, process or secret formula. However, a patent is limited in life by statute. The life of a particular package design is indefinite at the time of development. It potentially can be used by the owner forever.

Examples of the long lives of some famous package designs are contained in the article "Design Professionals Pick Some Favorites," Fortune, May 7, 1979, p.90. This clearly shows the potentially indefinite life of a package design. Examples in the article and the year of development include; the Camel Cigarette pack - 1913, The Arm & Hammer Baking Soda box - 1867, the Perrier Water bottle - 1910, the Michelob Beer bottle - 1961, and so on.

All costs incurred to arrive at the final accepted design are included in the definition of package design, just like any other asset. These costs may be paid to outside firms specializing in package design, or they may be handled by a subsidiary or in-house department of the company. The costs would include all expenses incurred, including: The initial design; intermediate designs, even though eventually rejected; and the final design, as all are integral and inseparable parts of the entire project (see note). Any costs incurred in defending the right to use the design would also fit this definition, such as legal fees in a lawsuit.

NOTE: In R.B. Haspel, 62 TC 59, Dec. 32549, the court ruled that abandoned architect’s plans for a foundation and structure were part of the eventual cost of the building and were not deductible as a loss. To further illustrate the concept of package design and its vital importance, reference is made to "The Image Makers" in Sky, July

1983, p.23, and "Packages Bear Up under a Bundle of Regulations," Fortune, May 7, 1979, p.181. In the Sky article, the author points out that the package "is the final point of contact between buyer and seller. Countless man-hours and millions of dollars invested by giant corporations have come down to those crowded few inches on the shelf and a product that must compete with hundreds of others to catch the cunsumer's attention and close the sale in a fraction of a second. Moreover, the company's name and reputation - its entire corporate image - may be wrapped up in that single package."

The author further state that "whether they are in-house designers or private practitioners, the value of the designer tactics (logo, color scheme, graphics and typography) in the company's strategic image-making is incalculable." Finally, the article quotes Charles Biondo, a leading American designer, as saying "over the years, successful products develop that equity that you just can't walk away from if you're redesigning an existing package." This point is elaborated upon in the Fortune article, which says "one cannot talk with a package designer long about his trade before hearing the work "equity." meaning, the recognizability value of an old package, even if it is an ugly one." To characterize the work of a package designer, the author states "at root, what they add to the product being packaged is the intangible of characterization."

LAW

Code section 263 does not allow a deduction for a capital expenditure. Regulation section 1.263(a)-2 gives examples of capital expenditures, and includes the cost of acquiring property having a useful life substantially beyond the taxable year. Numerous court cases have upheld the principle that a capital expenditure is not deductible. The Supreme Court, in United States vs. Mississippi Chemical Corp., 405 U.S. 298 (1972), held that the purchase of stock in a bank for farmer's cooperatives was a capital expenditure, stating:

> "Since the security is of value in more than one taxable year, it is a capital asset within the meaning of section1221 of the Internal Revenue Code, and its cost is non-deductible."

In Commissioner vs. Lincoln Savings and Loan Association, 403 U.S. 345 (1971), the Supreme Court ruled that a premium paid to the Federal Savings & Loan Insurance Corporation by a savings & loan was a non-deductible capital expenditure. The Court stated:

> "What is important and controlling, we feel, is that the Section 404(d) payment serves to create or enhance what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the

payment is capital in nature and not an expense, deductible under section 162(a)."

A similar conclusion was reached in Darlington-Hartsville Coca-Cola Bottling Co. vs. U.S., 68-1 USTC 9350, 393 F. 2d 494 (4 Cir. 1968), Cert. denied, 393 U.S. 962 (1968), where the taxpayer deducted amounts paid to the owner of a soft drink franchise to eliminate a middleman syrup distributor, thus reducing the cost of syrup. The court held that this payment was a non-deductible intangible asset with a potentially indefinite life, stating:

> "What does distinguish a capital expenditure, in this respect, is its intendment to produce a positive business benefit whose effects will be reaped in seasons beyond a single year....The contracts thus obtained were of indefinite duration, and were contrived to better the profits over the years to come."

In Richmond Television Corp. vs United States, 65-1 USTC 9395, 345 F 2d 901, 907 (4 Cir. 1965), the court held that an expenditure by a company to acquire the trained staff of another company was a capital asset. The court said:

> "A taxpayer may, therefore, not deduct as a current business expense the full cost of acquiring an asset, tangible or intangible, which benefits the taxpayer for more than one year."

Expenditures by a gas company for the services of solicitors to hold and develop customers in a strenuous competitive environment, and for the cost of installing free services lines on customers' property were held to be non-deductible capital expenditures in Houston Natural Gas Corp. vs. Commissioner, 90 F 2d 814, Cert. denied, 302 U.S. 722, 58 S Ct. 43. The court said:

> "A large list of satisfied customers on the books of this corporation is not merely an aggregation of disconnected individuals, but is a combination of business with a measurable degree of permanency."

Quoting Gauley Mt. Coal Co. vs. Commissioner, (C.C.A. 4th) 23 F (2d), the court stated:

> "Intangible property which enables a taxpayer to save or earn money, is as legitimate a form of capital investment as tangible property."

Finally, the Court Said:

> "....The gas corporation's campaign to get new business was highly

successful and resulted in benefits of lasting or permanent character."

There has been some recent dispute in various circuit courts in cases involving the determination of whether an expenditure is a capital asset or an expense. The dispute revolves around what is most important in making this determination; if benefit for more than the taxable year is controlling, or if the creation of a separate and distinct asset is controlling.

One case often cited in this regard is Briarcliff Candy Corp. vs. Commissioner, 475 F 2d 775 (2d Cir. 1973), where the costs incurred by a candy company in developing suburban markets for its products by contracting with local proprietors to display the company's goods were held by the Second Circuit to be deductible business expenses. The Internal Revenue Service had argued that these costs created valuable franchise agreements, and were non-deductible capital expenditures. The court felt that the Supreme Court in Commissioner vs. Lincoln Savings and Loan Assn. supra, had discounted the importance of future benefit (the one year rule) in considering whether an expenditure is capital in nature, instead stating that what is controlling is whether or not a separate and distinct asset is created. The IRS did not acquiesce in this decision.

Jack's Cookie Co. vs U.S., 79-1 USTC 9350, effectively reviews the history of this dispute as to whether the one year test or the creation of a separate and distinct asset test is controlling. The case held that a portion of lease payments made by the taxpayer were capital assets in that they were put into a reserve to retire bonds at some point in the future.

The court stated:

> "While the one year concept has been the focal point of controversy and decision in several cases, the rule is not, in itself, talismanic and we have never so held."

The court added:

> "But this is not to say that the potential of an expenditure to produce a business advantage over and beyond the tax year is irrelevant."

The court concluded that the tests went hand in hand, stating:

> "It is apparent that the 'separate assets' test of Lincoln Savings... necessarily incorporates the one-year rule and that in order to warrant capitalization of an expense, one integral characteristic of the 'separate and distinct asset' which is created or enhanced by the outlay, is that it

will serve the taxpayer in subsequent years."

In <u>Cleveland Electric Illuminating Company vs. U.S.,</u> U.S. Claims Court, No. 331-81T, Jan. 9, 1985, the disputes revolving around the one-year rule and the separate and distinct asset test were also reviewed. In this case, costs expended in training nuclear power plant employees and in advertising to lessen public fears of nuclear power plants were held to be capital expenditures. The company (plaintiff) argued that <u>Lincoln Savings and Loan</u> created new law and repudiated old law by stating that what was controlling in determining whether an expenditure was capital in nature was whether or not a separate and distinct asset was created. The court, in <u>Cleveland Electric Illuminating Co.</u> did not agree, stating that the one-year test was also used in <u>Lincoln Savings,</u> and that the controlling nature of the separate and distinct asset test in that case applied to the facts in <u>that</u> particular situation. The court in <u>Cleveland Electric</u> said:

> "It, (<u>Lincoln Savings</u>) does not state, as plaintiff urges, that if the separate and distinct asset test is not met, the payment is a necessary and ordinary expense.
>
> If plaintiff's construction of <u>Lincoln Savings & Loan Assn.</u> were correct, the Court would be deemed to have overruled without any discussion a host of Supreme Court and other decisions which held that particular expenditures were capital, or not ordinary, despite the fact that the expenditures at issue did not acquire or enhance 'separate and distinct assets.'"

The court goes on to list the numerous cases where this principle was upheld.

Finally, the court in <u>Cleveland Electric</u> says:

> "....Although the cost of replacing a broken window is a deductible expense in year of replacement, despite the benefits therefrom in ensuing years, the fact that a substantial expenditure is likely to give long-lived benefit, or is connected no dominant, factor in the direction of tangible or intangible capital asset treatment. This is because it enables matching of the revenues and the cost of producing them over the extended life of the asset."

<u>DEPRECIATION AND AMORTIZATION</u>

Code section 167 allows a reasonable depreciation deduction for the exhaustion, wear and tear (including obsolescence) of property used in a trade or business. However, Internal Revenue Regulation section 1.167(a)-3 provides that depreciation is allowable on an intangible asset if it is known from experience or other factors to be of use in business only for a limited period, the length of which can be estimated with reasonable accuracy. If the useful life is not limited, no depreciation is allowed. No allowance is permitted based upon the unsupported opinion of the taxpayer that the asset has a limited useful life.

TRADEMARK AND TRADE NAME COSTS

If the taxpayer registers the package design with the Commerce Department for protection under the trademark and trade name statutes (The Lanham Act of 1946, as amended), the costs would be eligible for the special write-off under Code section 177, providing all the requirements of that section are met.

The principal law governing trade names and trademarks is the Trademark Act of 1946, as amended (The Lanham Act), and it is administered by the Commerce Department. A trademark, as defined in Section 45 of the Act, "includes any word, name, symbol, or device, or any combination thereof adopted and used by a manufacturer or merchant to identify his goods and distinguish them from those sold or manufactured by others." The Act provides for the establishment of two registers, the Principal Register and the Supplemental Register, under which trademarks and trade names can be registered. Coined, arbitrary, fanciful or suggestive marks ("technical marks"), are registered on the Principal Register. Marks not qualified for this registration, but which distinguish the applicant's goods, may consist of any trademark, symbol, label package, configuration of goods, name, word, slogan, phrase, surname, geographical name, numeral, or device, or any combination of any of the foregoing. Trademarks and trade names have their origin in common law, and have long been protected there.

Expenses directly connected with the acquisition, protection, expansion, registration, or defense of a trademark or trade name are capital expenditures and are not deductible under Code section 162. These expenses are not depreciable or amortizable because they have indefinite useful lives, but they are permitted special treatment under Code section 177. These costs can be written off ratably over a period not less than 60 months, providing a proper, timely election is filed.

Section 177(c) provides that an election must be made during the time (including extensions) in which the taxpayer may file a return for the taxable year in which the expenses were incurred. In Revenue Ruling 79-333, 1979-2 C.B. 110, a retroactive election to write off these costs was not allowed when the taxpayer did not make a timely election, and the claimed expenses were disallowed upon examination. The following specific information must be included in the election per Regulation section

1.177-1(c):

1. Name and address of the taxpayer, and the taxable year involved.

2. An identification of the character and amount of each expenditure to which the election applies, and the number of continuous months (not less than 60) during which the expenditures are to be ratably deducted.

3. A declaration by the taxpayer that he will make an accounting segregation on his books and records of the trademark and trade name expenditures for which the election has been made, sufficient to permit an identification of the character and amount of each such expenditure and the amortization period selected for each expenditure.

ADVERTISING EXPENSES

Code section 162 allows ordinary and necessary expenses paid or incurred in carrying on any trade or business. Regulation section 1.162-1(a) includes advertising and other selling expenses as examples of business expenses. However, as previously outlined, Code section 263 does not allow a deduction for an expenditure that is capital in nature.

Advertising is the act of bringing awareness of one's business into public notice by paid announcements in periodicals, billboards, radio, television, or other media. For tax purposes, most advertising expenditures are recurring, and are considered to have limited period of time in which they are effective. This period of time is usually limited to the year of expenditure or the year following, but not beyond. However, an expenditure that is advertising related may also be a capital expenditure.

In Cleveland Electric Illumination Company vs. U.S., supra, the taxpayer undertook an advertising campaign to acquaint the public with the facts and merits of nuclear power in connection with the company's construction of a nuclear power plant. The program involved brochures, newspaper, radio and television. This advertising was held to be a non-deductible capital expenditure. The court stated:

> "....if the advertising serves the predominant purpose of contributing to the acquisition of a capital asset, tangible or intangible, which has value over an extended period beyond the taxable year, the costs of such advertising is not deductible for the taxable year, but must be amortized over its expected useful life period or added to the cost of the asset to which it contributes value."

In Alabama Coca-Cola Bottling, 28 TCM 635, Dec. 29, 626(M), TC Memo. 1969-123, a soft drink bottler could not deduct the cost of purchasing and installing advertising signs. They were held to be capital expenditures. In Northwestern Yeast Co., 5B.T.A. (232), the company expended large sums of money in an advertising and promotion campaign over a period of years. The court held that the expenditures could be capital, as they were incurred for the building up of future business. The court stated:

> "....promotion expenditures like those before us have a significance similar to the investment in more tangible assets. They fertilize the field for new production."
>
> "Generally and theoretically, therefore, it is safe to say that some part of the cost of a campaign or system of promotion may be of permanent significance and may be regarded as a capital investment rather than a deductible expense."

Another example of the Internal Revenue Service's position in regards to advertising related expenditures which are capital in nature is contained in Revenue Ruling 68-360, 1968-2 C.B. 197. This ruling addresses the proper treatment of costs incurred in the publication of a trade catalog by a wholesale distributor of hardware, industrial mill supplies, and other related items. The catalogs were not issued annually, and had a useful life of several years. The ruling held that "costs incurred in the publication of the taxpayer's trade catalog are not deductible as ordinary and necessary business expenses, but must be capitalized and depreciated over the useful life of the catalog." The Ruling also cited Best Lock Corporation vs. Commissioner, 31 TC 1217 (1957), which held that trade catalogs are no different from other assets used in a taxpayer's trade or business. Where the useful life of an asset exceeds one year, their cost should be capitalized and depreciated over that useful life.

RESEARCH AND DEVELOPMENT

Revenue Ruling 71-363, 1971-2 C.B. 156, states that expenditures by an advertising agency for investigative projects to develop new advertising concepts for distribution to clients are not research and experimental expenditures within the meaning of section 174 of the Code.

Internal Revenue Code section 174 provides for an expense-amortization election for research and development expenditures. Regulation Section 1.174-2(a) states that research and development expenditures are those incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental sense.

The term includes all such costs incidental to the development of an experimental or pilot model, a plan process, a product, a formula, an invention or similar property, and the improvements of existing property of the type mentioned. The term does not include expenditures for ordinary testing or inspection of materials or products for quality control or for efficiency surveys, advertising or promotion.

ORDINARY LOSS

Regulation section 1.165-2(a) states that a loss incurred in a business or a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any non-depreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under Code section 165(a) (ordinary loss). This would apply to that portion of an asset's basis which had not been previously deducted under the Code section 177 trademark and trade name election.

ARGUMENT

It is readily apparent that a package design is an asset. Creation of a package design does create a separate and distinct asset, with value for a potentially extensive period of time. A taxpayer clearly has a recognizable property interest in a package design. Whatever test the courts have applied in determining whether an item is a capital expenditure is met by package design costs. They do create a separate and distinct asset which does have a useful life in excess of the taxable year. The wide range of items considered to be assets under Code section 263 is illustrated by the cases cited in Law Section, ranging from the cost of acquiring a trained staff to the costs of soliciting and developing customers. Whether an asset is tangible or intangible has no bearing on this issue. Although an intangible asset has no physical presence, it is just as much of an asset as a building or a machine. When an asset promises to benefit future periods, deduction of its cost in the current period distorts income.

An important factor demonstrating the valuable asset status of a package design is the fact that it is defensible under specific state and federal statutes, and under an extensive body of common law. A package design may be registered with the Commerce Department for protection under the trademark and trade name laws. The definition of a mark eligible for registration on the Supplemental Register - any trademark, symbol, label, package, configuration of goods, name, word, slogan, phrase, surname, geographical name, numeral, or device, or any combination of the foregoing - obviously can encompass a package design. Even if a particular mark has not been registered, it is defensible under a large body of common law that has developed over the years. There are a large number of civil court cases, tried in both federal and state courts, involving the defense of a particular package design. These cases were tried under specific statutory authority (i.e., trademark infringement, unfair competition, etc.) or under common law.

Package design costs are not advertising expenses under Code section 162. Advertising expenses are considered to be recurring, and generally, are effective for a limited period of time. One could advance an argument that practically any expenditure a retailer makes is somehow connected to the sale of their products, and thus, is a deductible advertising expense. However, Code section 263 was specifically enacted to distinguish recurring, deductible expense items from non-deductible capital expenditures for assets having a useful life beyond the taxable year. The fact that a particular expenditure may be advertising related does not preclude its classification as a non-deductible capital expenditure. This issue is examined in the Alabama Coca-Cola Bottling Co. case, where it was held that advertising displays were capital expenditures, and were not currently deductible. It is also outlined in Revenue Ruling 68-360, 1968-2 CB. 197, and Best Lock Corporation vs. Commissioner, where costs incurred in the publication of a catalog with a useful life beyond the taxable year were held to be capital expenditures. Additionally, Cleveland Electric Illumination Co. held that an advertising campaign was a capital expenditure when it contributed to the acquisition of an asset.

The costs of developing a package design are not research and development expenditures under Code section 174. Package design does not encompass actual product or process development or improvement, a requirement under the narrow definition of research and development contained in the Regulations. Rather, it is a marketing related tool which fits the definition of items specifically excluded by Regulation section 1.174-2(a), such as management surveys, advertising, and so on. These expenditures, like package design, have no relation to product or process development or improvement. This concept is illustrated in Revenue Ruling 71-363, 1971-2 C.B. 156, where investigative projects for new advertising concepts were held not to be research and development expenditures.

A package design has no determinable life at the time of development. It potentially can be used for extended periods of time, which certainly cannot be estimated with reasonable accuracy. The extended lives of some famous package designs was elaborated upon in the Fortune article referred to previously. Once a package has developed a recognizability factor, and is associated with that manufacturer's business and products, there would be a strong business incentive not to change it.

An asset with no determinable life is not subject to depreciation or amortization. Code section 177 allows a special write-off period for qualified trademark and trade name expenditures (such as the cost of a registered package design), but only if a timely and specific election is made.

The Service has issued Private Letter Ruling 8611005, dated November 25, 1985, and related General Counsel Memorandum 39483, dated December 16, 1985. The private letter ruling stated that the package design costs at issue were capital expenditures under Code section 263, as they created identifiable intangible assets with useful lives in excess of the taxable year incurred. No depreciation or amortization was allowable under Code section 167, as the asset does not have a determinable useful life. Additionally, the package designs were held not to be trademarks eligible for the Code section 177 election, principally because the taxpayer did not offer evidence in this regard, and had in fact conceded that the package designs were not trademarks. The General Counsel Memorandum also held that package design development costs must be capitalized under section 263 because they create or enhance a tangible or intangible asset with a useful life greater than one year. The memorandum also stated that generally package design development costs are not trademark expenditures for purposes of section 177 and are not eligible for the amortization election. However, the memorandum also stated that this is a factual question that depends on whether the design is distinctive and its primary purpose is to indicate the taxpayer as the source of the product rather than to serve as ornamentation.

CONCLUSION

Package design costs are capital expenditures under Code section 263. They cannot be considered deductible expenses, as package design costs are incurred for the purchase of a separate and distinct asset with a useful life in excess of the taxable year. At the time of development, a package design does not have a determinable useful life, so amortization or depreciation under Code section 167 is not allowable.

Package design expenditures may qualify as trademark and trade name costs eligible for write-off under Code section 177, however, only if they are registered with the Commerce Department and if a timely and specific election is made. Package design costs do not qualify as research and development expenditures eligible for the expense/amortization election under Code section 174, as they are not related to product or process development or improvement. When a particular package design is abandoned, replaced, or discontinued for any reason, the accumulated costs can be written off under Code section 165 as an ordinary loss. This would apply only to that portion of the package design basis not deducted under Code section 177.

PACKAGE DESIGN COSTS DEFINED

Package design costs do not include items incorporated on a package which are clearly advertising in nature. These items could include coupon inserts, refund offers, pricing changes, addition of the works new, improved, or other generic terminology.

These minor, recurring items are not part of the original package design. These items are regularly put on a package and expensed. They are not the items which constitute the intangible asset. They are not capable of being registered with the Commerce Department as a trademark or trade name.

A distinction also has to be drawn between the original design of a package, or a new package design, and minor revisions of an existing package. Minor revisions do not create an intangible asset, while a new package design does. Each design is basically a factual determination based upon a comparison of the package design before and after the changes.

Additionally, the printing plates used to run off copies of the approved original package design are not included in the definition. These plates are clearly tangible property and do not have a direct relationship with the overall concept of the design. They are not part of the defensible, intangible asset which a package design represents. The Commerce Department does not register a printing plate as a trademark or trade name. The plates are also changed frequently when slogans, promotions, price changes, or any of the advertising-type expenses outlined in preceding paragraphs are added to or deleted from the original design. These plate costs are basically printing costs. They do not relate to the development of the design they are merely the means of transferring the completed package design to the packages or containers themselves.